RB 2010-02 Guidance on Accounting for Credit Losses

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Accounting for Credit Losses

Introduction

Financial results clearly show the continued stress in credit union loan portfolios. The operating environment remains challenging with increased levels of unemployment, weakened residential real estate markets and mounting strains in the commercial real estate market. The combination of these factors has led to a growing level of nonperforming loans and foreclosures in the Texas credit union system. Additionally, there is a rising level of performing loans with underlying credit or documentation issues. Therefore, the Department is issuing this reminder regarding the importance of accurately accounting for credit losses.

Asset quality reviews continue to be a significant focus in examinations. Examiners continue to identify situations where credit unions have not provided for timely charge offs of nonperforming loans or established an adequate level of loan loss allowances relative to the credit union's risk exposures. Of particular concern is the increasing number of credit unions that do not have policies, procedures and written documentation related to impaired loans that are consistent with accounting standards.

Allowance for Loan and Lease Losses (ALLL)

The calculation of the ALLL represents one of the most significant estimates included in a credit union's financial statements. While generally accepted accounting principles regarding how to account for the provision and the ALLL have not changed in recent years, the current economic environment may require credit unions to reassess whether the information upon which the credit union bases its accounting decisions remains accurate. It is imperative that each credit union maintain an ALLL that is the result of a comprehensive and consistently applied process.

The ALLL should be maintained at a level appropriate to absorb estimated losses inherent in the loan portfolio, and should be well documented with clear explanations for supporting analysis, methodology and rationale. Credit unions should consider all significant factors, both positive and negative, that affect the collectability of loans. Credit unions that primarily use lagging data in their ALLL methodology for higher-risk loans should supplement and validate it with other methods that use more leading data when available. In addition, effective procedures to identify impaired loans and troubled debt restructuring are needed, as well as enhanced valuation analysis to ensure that the resulting loans are accounted for at appropriate valuations. The result should be an ALLL that is prudent and appropriate but not excessive.

Conclusions

Credit union management is responsible for maintaining appropriate accounting systems and documentation to support appropriate loan loss recognition. As we approach mid-year financials, the Department encourages credit union management to reassess its processes and systems for estimating credit losses and maintaining an appropriate ALLL.

In addition, Boards of Directors should ensure that future annual audits include appropriate review procedures to assess the effectiveness of the accounting for ALLL, appropriate loan loss recognition, and financial reporting and disclosures.